

# ***Indiana Legislative Services Agency***

## ***Fiscal Issue Brief***

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### **Business Tax Credits and Deductions in Indiana**

There is little information available on the use of various deductions and tax credits by businesses under Indiana's individual and corporate income tax systems.<sup>1</sup> This issue brief summarizes the results of a project to determine the utilization of deductions and tax credits by businesses in Indiana. It also examines how deductions and credits fluctuate with the business cycle.

#### **Business Deductions and Tax Credits from Individual Income Tax Returns**

In 2001 just over 1.0 million individual income tax returns (Form 1040) included at least one type of business income.<sup>2</sup> This represents about 33 percent of all individual income tax returns filed in Indiana in 2001. Table 1A shows basic statistics for returns with business income claiming the Net Operating Loss (NOL) deduction and the various tax credits available to businesses through the individual income tax system in 2001.

Overall, no more than 8% of the returns containing business income claimed the NOL deduction or the available credits. The Indiana NOL deduction is a deduction of the Indiana portion of federal net operating loss. Net Operating Loss is defined as the excess of allowable deductions over gross income (with required adjustments). Unused NOL deduction(s) may be carried forward up to 15 years (20 years following certain federal provisions) or carried back up to 3 years. Of the available business tax credits, the college credit is the most widely used (claimed on almost 69,360 returns) followed by the Neighborhood Assistance Credit (claimed on just over 3,000 returns). See the Appendix for a brief overview of each type of credit and deduction.

#### **Corporate Deductions and Tax Credits**

In 2001 approximately 39,450 Indiana corporate income tax returns were filed, including about 580 returns from financial institutions, 21,600 returns from C-corporations, and 17,250 returns from special corporations.<sup>3</sup> Table 2A shows the basic statistics for the major deductions and credits available to businesses through the corporate income tax system in 2001. The NOL deduction (claimed on 5,532 returns) and the dividend deduction (claimed on 3,034 returns) were the most widely used deductions in 2001. Utilization of credits on corporate returns was well below the utilization levels for these deductions. The college credit (claimed on 259 returns) and the research expense credit (claimed on 131 returns) were the most used credits.

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<sup>1</sup> National aggregates are available for federal business credits and deductions. See for example Altounian, Lucy and Contos, George, "Corporation Income Tax Returns, 2000" *Statistics of Income Bulletin*. Washington, D.C.: Internal Revenue Service, Summer 2003, and Campbell, David and Parisi, Michael, "Individual Income Tax Returns, 2001" *Statistics of Income Bulletin*. Washington, D.C.: Internal Revenue Service, Fall 2003.

<sup>2</sup> Forms of business organization commonly taxed under individual rather than corporate income tax systems include sole proprietorships, partnerships, S corporations, and various other joint ventures except C corporations. Returns with capital gains or losses and dividend income are also included. Analysis from the Indiana individual income tax returns is based on the number of returns available in LSA databases as of November 2003.

<sup>3</sup> Corporate income tax returns in Indiana are IT-20 for C corporations, FIT-20 for financial institutions and IT-20SC for special corporations that could file as S corporations through the individual income tax system but that choose to file a corporate return. In addition, over 124,000 information returns were filed for partnerships and S corporations using IT-65 and IT-20S returns and are not included in the analysis. Analysis of the Indiana corporate income tax returns is based on the number of corporate returns available in LSA databases as of May 2004.

**Table 1A: Business Deductions and Credits from 2001 Individual Income Tax Returns**

	Number of Returns	Average (\$)	Std. Deviation <sup>b</sup> (\$)	Total (\$)	25 <sup>th</sup> Percentile <sup>c</sup> (\$)	Median (\$)	75 <sup>th</sup> Percentile (\$)
NOL Deduction	1,315	22,943	70,613	30,169,800	2,654	7,345	20,076
College Credit	69,360	101	71	6,996,840	38	100	200
Research Expense Credit	385	3,122	7,970	1,201,847	313	1,027	2,645
Neighborhood Assistance Credit	3,002	661	1,869	1,983,204	75	200	500
Enterprise Zone Credits	141	2,338	4,841	329,708	260	720	1,854
Teacher Summer Employment Credit	8	1,123	878	8,982	200	1,202	1,840
21 <sup>st</sup> Century Scholars Program Credit	54	98	69	5,308	37	100	189
Other Credits <sup>a</sup>	721	936	2,405	675,193	25	130	957

Source: LSA analysis of Indiana Department of State Revenue data.

<sup>a</sup> May include Maternity Home Credit, Historic Rehabilitation Tax Credit, Riverboat Building Credit, Industrial Recovery Tax Credit, Military Base Recovery Tax Credit, Individual Development Account Credit, Community Revitalization Enhancement District Credit, Capital Investment Tax Credit, Refined Lubricated Oil Facility Tax Credit.

<sup>b</sup> The standard deviation is the average difference between each observation and the mean.

<sup>c</sup> Twenty-five percent of returns have a net income (net loss) below the 25<sup>th</sup> percentile, while 75 percent of returns have a net income (net loss) higher than this value. Fifty percent of returns are below the median, and 75 percent of returns are below the 75<sup>th</sup> percentile. Maximum and minimum values are not reported due to confidentiality concerns.

**Table 2A: Corporate Deductions and Credits from 2001 Corporate Income Tax Returns**

	Number of Returns	Average (\$)	Std. Deviation (\$)	Total (\$)	25 <sup>th</sup> Percentile (\$)	Median (\$)	75 <sup>th</sup> Percentile (\$)
<b>DEDUCTIONS</b>							
NOL Deduction	5,532	118,400	1,050,467	654,986,965	1,926	8,563	32,751
Net Qualifying Dividend Deduction	3,034	30,564,588	298,419,242	92,732,958,757	712	6,212	433,910
Interest on U.S. Government Obligations	1,056	3,163,425	32,840,998	3,340,576,955	992	10,954	103,782
Foreign Gross Up	419	12,066,134	35,028,488	5,055,710,150	181,438	1,237,641	6,550,000
Nonbusiness Income	936	10,904,359	78,389,325	10,206,480,070	9,122	50,447	544,441
<b>CREDITS</b>							
College Credit	259	412	392	106,801	69	250	950
Research Expense Credit	131	164,871	862,417	21,598,044	2,772	7,336	31,577
Neighborhood Assistance Credit	68	2,288	3,964	155,608	250	672	2,685
Enterprise Zone Employment Expense Credit	55	12,019	29,973	661,062	1,278	2,722	8,492
Enterprise Zone Loan Interest Credit	28	58,897	87,224	1,649,116	5,270	23,400	73,907
Comprehensive Health Insurance Association Credit	10	42,463	46,889	424,627	3,777	25,219	79,922
Other Credits <sup>a</sup>	43	100,019	219,478	4,300,805	2,500	12,093	85,630

Source: LSA analysis of Indiana Department of State Revenue Data.

<sup>a</sup> May include Guaranty Association Credit, Maternity Home Credit, Historic Rehabilitation Tax Credit, Industrial Recovery Tax Credit, Military Base Recovery Tax Credit, Individual Development Account Credit, Community Revitalization Enhancement District Credit, Capital Investment Tax Credit, Teacher Summer Employment Tax Credit, Investment Cost Credit, Prison Investment Tax Credit (2001), Twenty-First Century Scholars Program Support Fund (2001), Comprehensive Health Insurance Association Credit (1999), Refined Lubricated Oil Facility Tax Credit (FIT-20, 2001). The Comprehensive Health Insurance Association Credit was listed on the IT-20 tax return beginning in 2001 but was included with Other Credits in previous years.

## **Business Cycle Influences**

Business deductions and credits from 1999 are compared to those for 2001 to examine the fluctuation in deduction/credit utilization and amounts with the business cycle. Return counts and other descriptive statistics for 1999 are detailed in Tables 1B and 2B for individual and corporate returns, respectively. The year 1999 was in a period of economic expansion, while 2001 was in a recessionary period.

During an economic downturn, taxable income decreases and more firms experience losses. As a result, fewer businesses are expected to claim tax credits and deductions, and credit and deduction amounts are expected to be lower. While this pattern is not clearly reflected by businesses filing individual income tax returns (displayed in Tables 1A and 1B), it is reflected by corporations as displayed in Tables 2A and 2B. For each deduction and credit claimed by corporate filers, the number of returns is lower in 2001 than in 1999, and the magnitude of the deductions and credits also declines from 1999 to 2001. For those deductions and credits showing reduced use and claimed amounts by corporations, the decline in utilization totaled about 18% with an average decline of 30% in terms of claimed amounts. The exception for corporate filers is the Enterprise Zone Loan Interest Credit. While use of the credit decreased about 15% from 1999 to 2001, the amount claimed was actually about 10% higher in 2001.

The pattern is less clear for credits of businesses filing individual income tax returns. For these businesses, utilization and claimed amounts were down substantially for the Research Expense Credit and the NOL Deduction. While use of the Research Expense Credit was down about 13% and the NOL deduction about 38%, the claimed amounts were down about 22% and 83%, respectively. In contrast, the number of returns claiming the Neighborhood Assistance Credit, Enterprise Zone Credits, Teacher Summer Employment Credit and other credits actually increased between 1999 and 2001, as did the amount claimed. Most notably, utilization and claimed amounts for the Neighborhood Assistance Credit increased by roughly 21% from 1999 to 2001, and Enterprise Zone Credits more than doubled during this period.

For credits which are approved in advance, such as the Enterprise Zone Investment Cost Credit, the Riverboat Building Credit, the Industrial Recovery Credit, and others, businesses may qualify for more credit than is actually taken. Due to the business cycle or other types of tax reduction strategies, a business may have low or no tax liability in a given year and therefore not benefit from tax credits.

While the dollar amounts reported for the 1999 and 2001 credits are not strictly comparable because the 1999 amounts are not adjusted for inflation, general comparisons can be made. The inflation rate was 6.3 percent between 1999 and 2001 as measured by the Consumer Price Index for urban consumers.

**Table 1B: Business Deductions and Credits from 1999 Individual Income Tax Returns**

	Number of Returns	Average (\$)	Std. Deviation* (\$)	Total (\$)	25 <sup>th</sup> Percentile (\$)	Median (\$)	75 <sup>th</sup> Percentile (\$)
NOL Deduction	2,114	83,147	591,644	175,771,773	3,594	12,297	43,556
College Credit	67,102	101	71	6,769,103	36	100	200
Research Expense Credit	442	3,508	12,456	1,550,635	183	896	2,501
Neighborhood Assistance Credit	2,483	655	1,894	1,625,155	59	175	500
Enterprise Zone Credits	55	2,608	3,593	143,450	414	1,224	3,618
Teacher Summer Employment Credit	5	666	804	3,332	70	100	1,546
21 <sup>st</sup> Century Scholars Program Credit	59	91	71	5,341	25	100	135
Other Credits*	389	1,176	3,873	457,486	16	50	373

\* See footnotes for Table 1A.

**Table 2B: Corporate Deductions and Credits from 1999 Corporate Income Tax Returns**

	Number of Returns	Average (\$)	Std. Deviation (\$)	Total (\$)	25 <sup>th</sup> Percentile (\$)	Median (\$)	75 <sup>th</sup> Percentile (\$)
<b>DEDUCTIONS</b>							
NOL Deduction	6,706	172,594	1,560,761	1,157,416,907	2,873	12,005	44,097
Net Qualifying Dividend Deduction	3,615	36,639,476	560,535,069	132,451,704,614	813	8,885	644,426
Interest on U.S. Government Obligations	1,200	3,320,548	35,912,572	3,984,657,085	1,470	12,435	105,912
Foreign Gross Up	535	17,433,675	71,524,930	9,327,016,200	210,991	1,272,991	5,972,370
Nonbusiness Income	1,254	9,888,574	71,904,376	12,400,271,754	10,123	66,374	948,204
<b>CREDITS</b>							
College Credit	365	436	398	159,269	59	275	1,000
Research Expense Credit	149	173,508	1,456,626	25,852,667	3,164	11,005	32,278
Neighborhood Assistance Credit	72	4,097	7,254	294,994	250	500	4,688
Enterprise Zone Employment Expense Credit	78	9,327	20,725	727,521	518	2,071	7,807
Enterprise Zone Loan Interest Credit	33	45,277	86,395	1,494,149	3,189	23,604	54,630
Other Credits*	69	76,336	222,022	5,267,181	1,895	12,811	58,336

\* See footnote for Table 2A.

### **The Cost of Business Deductions and Credits**

The fifth column of each table shows the total amount of the deduction or credit that was claimed during the tax year. Because credits are a dollar-for-dollar reduction in tax liability, the amount represents the tax expenditure – the amount of tax revenue foregone – as a result of the credit. In contrast, amounts relating to deductions reflect only a lowering of taxable income. For deductions, the tax expenditure is equal to the tax rate multiplied by the amount of the deduction.

For businesses filing individual income tax returns, the tax expenditure attributable to the NOL deduction is \$0.97 million (3.2% of \$30.2 million)<sup>4</sup> for 2001 and \$5.6 million for 1999. The average reduction in taxes from the NOL deduction totaled about \$730 in 2001, but was over three times higher in 1999 at about \$2,660. In both years, the NOL deduction exhibited significant variability, with a standard deviation of over \$70,000 in 2001 and over \$590,000 in 1999. The tax expenditure attributable to tax credits is \$11.2 million in 2001 (\$10.6 million in 1999). On average, however, the Research Expense Credit and, to a lesser extent, the Enterprise Zone Credits provide the largest tax reductions for businesses filing as individuals - with the former averaging about \$3,000 in 2001 and \$3,500 in 1999, and the latter averaging about \$2,300 in 2001 and \$2,600 in 1999. The total tax expenditure attributable to the NOL deduction and various business tax credits available through the individual income tax system is approximately \$12.2 million in 2001 and \$16.2 million in 1999.

For corporate returns, the tax expenditure attributable to deductions was \$7.8 billion (7.0% of \$111.9 billion) in 2001 and \$11.2 billion in 1999. The tax expenditure attributable to credits is \$28.9 million in 2001 and \$33.8 million in 1999. The combined tax expenditure for deductions and credits is \$7,840 million in 2001 and \$11,152 million in 1999.

The combined tax expenditure for business tax credits available through the corporate and individual income tax systems totaled \$40.1 million in 2001, 0.41% of total state tax collections in FY 2001, and \$44.4 million in 1999, 0.45% of total state tax collections in FY 1999. The tax expenditure attributable to deductions is substantially

<sup>4</sup> The effective individual income tax rate is 3.2 percent and the effective corporate tax rate is 7.0%. The effective tax rate is calculated as tax liability (after credits are taken) as a share of taxable income. It is the average tax rate paid by taxpayers.

higher at \$7.8 billion in 2001, 79% of total state tax collections, and \$11.2 billion in 1999, which was about 14 percent more than total state tax collections.

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## Appendix

### **Overview of 2001 Tax Credits** (Certain aspects of these credits may have changed since 2001.)

As noted below, several tax credits are available to businesses and individuals. It is not possible to distinguish between individuals and businesses taking these credits on the individual income tax return. The calculations presented in this paper are from returns with at least one form of business income.

**College Credit:** (May be a business or individual credit.) Credit for the donation of money or property to an Indiana college or university. The maximum credit is \$200 on the individual income tax form or \$1,000 on the corporate income tax form. Form: CC-40

**Research Expense Credit:** Credit for research and experimental expenses paid in carrying on trade or business in Indiana. The credit is 5 percent of the increase in qualified research expenses incurred in the current year over the taxpayer's base amount. The base amount is the same as is used for federal tax purposes. Unused credit may be carried forward for up to 15 years. Schedule IT-20REC. (With the 2002 tax restructuring the credit increased to 10 percent of the increase in qualified research expenses.)

**Neighborhood Assistance Credit:** (May be a business or individual credit.) Credit for contributions to a qualified organization participating in the Neighborhood Assistance Program (NAP) to upgrade areas in Indiana. Fifty percent of the contribution is eligible for the credit, up to a maximum of \$25,000. Indiana limits the total NAP credits to \$2.5 million per state fiscal year. Applications for the credit are considered in chronological order by the Department of State Revenue. Form: NC-20

**Enterprise Zone Credits/Airport Development Zone Credits:** There are three income tax credits.

**Loan Interest Credit:** A 5 percent tax credit on interest income from a loan that benefits businesses or residents of an Enterprise Zone. To qualify, the loan must directly benefit an Enterprise Zone business; increase the assessed value of real property in an Enterprise Zone; or be used to rehabilitate, repair, or improve a residence in a zone. To claim the loan interest credit, an individual or business must: Indicate the amount of credit for which they are eligible on Schedule LIC and file Schedule LIC with annual tax return.

**Employment Expense Credit:** Credit for wages paid to qualified employees. A "qualified employee" is one who lives in the enterprise zone, works 50 percent of his or her time in the enterprise zone and has at least 90 percent of his or her services directly related to the employer's facility in the enterprise zone. The annual credit is applied after all other Indiana credits against state income tax liability (either gross income tax or adjusted gross income tax). Credit earned that exceeds tax liability may be carried back or brought forward to other tax years. To claim the employment expense credit, an employer must: Indicate the amount of the credit for which they are eligible on Schedule EZ and file Schedule EZ with annual tax return.

**Investment Cost Credit:** An individual purchasing an ownership interest in an Enterprise Zone business may be eligible to receive a credit of up to 30 percent of the purchase price against his or her state tax liability. To claim the investment cost credit, an individual must request that the Indiana Department of Commerce (IDOC) determine if the purchase is a qualified investment. This must be done before the purchase is made. If the purchase is a qualified investment, the IDOC will then determine the precise percentage of the tax credit the individual may claim and attach certification documents to individual tax return (The IDOC will provide the taxpayer with certification documents).

**Teacher Summer Employment Credit:** Credit for hiring math or science teachers during the summer vacation. Qualified positions must be certified by the Department of Education and the certification must be attached to the tax form. The credit is equal to the lesser of \$2,500 or half of the compensation paid for corporations. Schedule TSE

**21<sup>st</sup> Century Scholars Program Credit:** (May be a business or individual credit.) Credit for contributions to the Twenty-First Century Scholars Program Support Fund. The credit is equal to 50 percent of the contribution made during the tax year up to a maximum of \$100 for a single return and \$200 for a joint return for individuals and a maximum of \$1,000 for corporations. Schedule TCSP-40

**Other Credits** (Some credits may be taken as business credits or individual credits.)

**Maternity Home Credit:** Credit for maternity home owners providing a temporary residence to at least one pregnant woman for at least 60 consecutive days during her pregnancy. The maternity home owner must annually file an application with the State Department of Health to be eligible to claim the credit and attach the approved application to the tax return.

**Historic Rehabilitation Tax Credit:** (May be a business or individual credit.) Credit for the rehabilitation or preservation of a historic building that is listed on the Indiana Register of Historic Sites and Structures, is at least 50 years old and is income-producing. The cost of rehabilitation or preservation must exceed \$10,000. A credit of 20 percent of the cost of the qualified rehabilitation or preservation expenses may be taken against state income tax liability. Any unused balance of the credit may be carried forward for up to 15 years. Qualified projects must be certified by the Division of Historic Preservation and Archaeology of the Indiana Department of Natural Resources.

**Riverboat Building Credit:** Credit for any individual or company that builds or refurbishes a riverboat licensed to conduct legal gambling in Indiana. The credit is equal to 15 percent of the qualified investment and can be carried forward to subsequent tax years. The Indiana Department of Commerce must approve the costs of the qualified investment before the costs are incurred.

**Industrial Recovery Tax Credit:** Credit based on a taxpayer's qualified investment in a vacant industrial facility located in a designated industrial recovery site. If the Enterprise Zone Board approves the application and the plan for rehabilitation, the taxpayer is entitled to a credit based on the "qualified investment".

**Military Base Recovery Tax Credit:** Credit for investing in the rehabilitation of real property located in a military base recovery site according to a plan approved by the Enterprise Zone Board.

**Individual Development Account Credit:** (May be a business or individual credit.) Credit available for contributions made to a community development corporation participating in an Individual Development Account (IDA) program. The IDA program is designed to assist qualifying low-income residents to accumulate savings and build personal finance skills. The organization must have an approved program number from the Indiana Department of Commerce before a contribution qualifies for pre-approval. The credit is equal to 50 percent of the contribution, which must not be less than \$100 or more than \$50,000. S corporations and partnerships may take this credit and pass through the unused portion to their shareholders and partners. Applications for the credit are filed through the community development corporation, and an approved form must be attached to the tax return.

**Community Revitalization Enhancement District Credit:** Credit for a qualified investment made within a community revitalization enhancement district. The expenditure must be made under a plan adopted by an advisory commission on industrial development and approved by the Indiana Department of Commerce before it is made. The credit is equal to 25 percent of the qualified investment made by the taxpayer during the taxable year. S corporations and partnerships are not eligible for this credit. The taxpayer may carry forward any excess credit in the next tax year. The credit may offset both state and local tax due.

**Capital Investment Tax Credit:** (Effective beginning January 1, 2001) Credit based on certain qualified capital investments made in Shelby County.

**Rerefined Lubricated Oil Facility Tax Credit:** (Effective January 1, 2001, through December 31, 2005) Credit based on a percentage of the real and personal property taxes paid by an entity that processes rerefined lubrication oil. The credit can be taken against income and sales and use tax liabilities.

**Guaranty Association Credit:** A tax credit for up to 20 percent of an assessment that an insurance company pays to either the Indiana Insurance Guaranty Association or the Indiana Life and Health Insurance Guaranty Association.

**Indiana Comprehensive Health Insurance Association Credit:** A nonrefundable credit against the income tax liability of an insurance company who pays an assessment to the Indiana Comprehensive Health Insurance Association.

### **Overview of 2001 Deductions**

**Net Operating Loss (NOL) Deduction:** Indiana NOL deduction is a deduction of the Indiana portion of federal net operating loss. Net Operating Loss is defined as the excess of allowable deductions over gross income (with required adjustments). Unused NOL deduction(s) may be carried forward up to 15 years (20 years following certain federal provisions) or carried back up to 3 years.

**Net Qualifying Dividend Deduction:** A deduction for dividends received from a domestic corporation that is subject to income tax.

**Interest on U.S. Government Obligations:** A deduction for interest on U.S. government obligations included on the federal income tax return less all related expenses.

**Foreign Gross Up:** Deduction for dividends received from certain foreign corporations by domestic corporations using the foreign tax credit.

**Nonbusiness Income and Non-unitary Partnership Distributions:** Nonbusiness income is defined as income that is not classified as business income, where business income is income earned from transactions and activities in the regular course of trade or business. Some examples of nonbusiness income are dividends from stock or interest from securities held for investment purposes only and capital gain or loss from the sale of property held for investment purposes only. Such income is deductible for Indiana income tax purposes.

**Sources:** Indiana Department of Revenue, 1999 and 2001 IT-40, IT-20, and FIT-20 Instruction Booklet and the various credit and deduction forms and schedules. Indiana Department of Commerce for information on enterprise zone credits. Commerce Clearing House, 2001 Master Tax Guide.